TAX FACTS

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ILLINOIS TAX EXPENDITURES: LOTS MORE THAN TAX INCENTIVES

By Rob Ross

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Introduction

In FY2012, the state of Illinois collected $30.187 billion in general funds tax revenues, but it would have collected an additional $8.3 billion dollars were it not for tax expenditures. Through tax expenditures the state forewent 27 percent of total general funds tax revenues. Tax expenditures constitute a large portion of Illinois' state revenues and expenditures, and those looking to reform Illinois' tax code should understand how tax expenditures currently function in Illinois' revenue structure.[1]

This article does three things. First we define tax expenditures and discuss their role in public policy. Then we describe tax expenditures in Illinois and major changes in tax expenditures since 2000. Finally, we conclude with a discussion of specific tax expenditures: Economic Development for a Growing Economy (EDGE) credit, the Manufacturing Machinery and Equipment

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[1] All data for this primer is from the Illinois Comptroller's Office unless otherwise noted.

NOTES FROM THE INSIDE. . .

By Carol S. Portman

We dedicate this issue of Tax Facts to one of the perennial "hot topics" of Illinois state finances – particularly when lawmakers are looking for more resources – tax expenditures. Our research assistant, Rob Ross, chronicles the growth of tax expenditures, reviews tax policy implications, and points out that many expenditures have been enacted to remedy flaws in our tax code. Rob concludes that tax expenditures are not, as they are often portrayed, tax incentives. He also points out that the primary beneficiaries of tax expenditures are individuals, not charities or businesses, and that most of the growth has been in tax expenditures that benefit individuals.

Rob's second article focuses on Illinois' Net Operating Loss deduction, Illinois' largest corporate income tax expenditure. The NOL is also the tax expenditure that has been tinkered with most often in the last decade as Illinois has moved farther and farther away from federal treatment. I think Rob's examples clarify to anyone interested the role of the NOL deduction in sound tax policy.

Pieces like these seek to fulfill our mission of providing policy makers with sound information upon which to make decisions (and often to counter unsound information). You may have seen the report that we, along with the State Chamber of Commerce, commissioned on "why" corporations don't pay Illinois corporate income tax. We undertook that project to counter the innuendo that corporations must be doing something unsavory because two thirds of them don't pay tax. We will have a summary of that report in our next Tax Facts.

Exemption (the same analysis applies to the Graphic Arts Equipment Exemption), the retirement income subtraction, and the property tax credit. The Net Operating Loss deduction is also discussed in in more detail in "Matching Taxation to the Business Cycle" on page 12.

In FY2012, the state of Illinois collected $30.187 billion in general funds tax revenues, but it would have collected an additional $8.3 billion dollars were it not for tax expenditures. As we have classified them, 18 percent of tax expenditures are designed to remedy flaws in the tax code, 5 percent to incent a specific behavior, and 77 percent to make the tax code fairer. Tax expenditures have grown slightly faster than general funds revenues, general funds spending, and the state economy. Most tax expenditures, and nearly all the growth in tax expenditures, benefits individual taxpayers.

What is a tax expenditure?

A tax expenditure is an exemption, exclusion, deduction, allowance, credit, preferential tax rate, abatement, or other tax structure that reduces the amount of tax revenues the state collects, according to the Illinois Comptroller's Office. The three largest tax expenditures in FY2012 were, in order of size, the Retirement and Social Security deduction ($1.9 billion), the Food, Drug and Medical Appliances Exemption ($1.63 billion) and the Standard Exemption on individual income taxes ($1 billion). The first of these allows taxpayers to exclude retirement income from taxation on their personal income tax returns. The second exempts grocery and medicine purchases from sales taxes. And the third reduces taxable income by $2,100 for each taxpayer and dependent in a household. Together, these tax expenditures account for about 55 percent of Illinois' total tax expenditures.[2]

Are tax expenditures "loopholes"?

Often tax expenditures are pejoratively referred to as "tax giveaways" or "corporate tax loopholes," and lawmakers frequently consider cuts to tax expenditures when more tax revenue is needed. All this conveys the sense that tax expenditures are bad public policy. This is not necessarily true; tax expenditures can serve a number of legitimate policy goals. As with any law, however, there is potential for misuse, and it is important to recognize the policy reasons motivating each tax expenditure. A detailed discussion of the merits and demerits of various tax expenditures is outside the purview of this article. Here we give a general evaluative framework to help policy makers and the public evaluate specific tax expenditures.

What policy goals do tax expenditures try to achieve?

Conceptually, tax expenditures can be categorized in two ways. Either they are designed to remedy problems with the tax code, or they are a form of state spending (or both). In general, tax expenditures as state spending can be further divided into spending designed to incent behavior, and spending designed to promote fairness. These divisions are useful in thinking about and evaluating tax expenditures, but are not necessarily clearly defined or mutually exclusive. **Table 1** below shows the general breakdown of tax expenditures by policy category. Note that the Taxpayers' Federation of Illinois categorized 91 percent of all tax expenditures in FY2012.

TABLE 1. General Breakdown of Tax Expenditures by Policy Category

Category	Total	Percent
Incentives	$391,224	5%
Fairness	$5,839,299	77%
Correct Problems With the Tax Code	$1,347,457	18%

As noted above, 18 percent of tax expenditures reported by the Illinois comptroller's office are designed primarily to correct issues with the tax code. Sometimes, the Illinois tax code results in perverse outcomes for taxpayers, and Illinois has used tax expenditures to adjust these outcomes. For example, sales taxes levied against the value of all transactions can lead to the same product being taxed three or four times. The Manufacturing Machinery and Equipment Exemption works to correct this issue by exempting purchases of manufacturing equipment from taxation. We discuss this more below. Another example of perverse tax outcomes is the Net Operating Loss Deduction. Under the Illinois Tax Code, taxpayers first add

[2] Detailed information on Illinois' tax expenditures can be found on the Illinois Comptrollers' website. Data for this article came from the Comptrollers' annual report on tax expenditures. http://www.ioc.state.il.us/index.cfm/resources/reports/tax-expenditure/fy-2012/

TAX EXPENDITURE REPORT BY REVENUE SOURCE							
Revenue Source & Annual Receipts: Sales and Use Tax	**Year 1993**	**Year 1999**	**Year 2000**	**Year 2001**	**Year 2002**	**Year 2003**	**Year 2004**
Food, Drugs, and Medical Appliances Rate Reduction	$675,000	$918,000	$1,050,000	$1,100,000	$1,160,000	$1,169,000	$1,222,500
Sales to Exempt Organization	$450,000	$557,982	$670,000	$667,200	$874,000	$892,791	$930,356
Traded-In Property Exemption	$200,000	$300,000	$325,000	$325,000	$350,000	$339,147	$343,283
Farm Chemicals (Includes Feed and Seed) Exemption	$130,000	$164,000	$185,000	$190,000	$200,000	$204,300	$208,795
Manufacturing, Assembling Machinery & Equip. Exemption	$100,000	$127,200	$143,600	$147,300	$155,000	$158,332	$161,816
Retailer's Discount	$93,000	$89,760	$102,950	$102,150	$104,000	$107,300	$113,363
Gasohol Discount		$28,200	$41,300	$50,400	$46,400	$60,000	$62,539
Biodiesel Discount and Exemption							
Rolling Stock Exemption	$40,000	$70,000	$127,500	$70,000	$92,000	$104,133	$42,225
Farm Machinery and Equipment Exemption		$39,100	$44,200	$50,400	$45,000	$45,968	$46,979
Gas Tax Holiday (State Sales Tax Exemption on Motor fuels)				$163,000			
Sales of Motor Vehicles to Non-Resident Exemption	$38,000	$50,600	$75,000	$46,000	$75,500	$72,040	$70,474
Revenue Source & Annual Receipts: Individual Income Tax							
Federally Taxed Retirement and Social Security Subtractions	$284,100	$553,805	$639,816	$714,420	$716,940	$732,055	$757,659
Standard Exemption: Taxpayers and Dependents	$305,700	$418,016	$553,618	$682,895	$686,278	$680,399	$690,357
Tax Credit for Residential Real Property Taxes	$192,000	$288,000	$303,400	$317,933	$337,405	$355,552	$383,615
Earned Income Tax Credit				$39,921	$44,148	$50,830	$65,746
Education Expense Credit				$61,233	$68,444	$66,518	$67,140
Other Subtractions		$30,000	$36,137	$39,962	$39,197	$48,781	$55,004
Revenue Source & Annual Receipts: Corporate Income Tax							
Illinois Net Operating Loss Deduction	$62,400	$137,810	$126,096	$141,779	$144,651	$102,943	$162,938
Source: Office of the Illinois Comptroller							

back their federal NOL, then subtract out an apportioned net operating loss from their apportioned income (the subtraction being labeled as the tax expenditure). This is discussed further in the NOL Primer on page 12.

Most tax expenditures can be characterized simply as a form of state spending. Most people are familiar with direct spending – the government collects taxes and then spends that revenue for public purposes. However, the government can also spend money by forgoing revenue it would otherwise have collected. A hypothetical scenario illustrates the choice that policy makers have between direct spending and spending by way of a tax expenditure. Consider a company that researches new ways to make biofuel, and suppose that the state wants to encourage this sort of research. One way to do that is to simply make a grant to companies that engage in biofuel R&D. This would be considered a direct expenditure. Another way would be to create a tax deduction, or a similar tax instrument, that reduces R&D companies' tax liabilities. This would be considered a tax expenditure. From the perspective of public policy, these are just two different ways the state can spend money to encourage R&D.

Table 2 on page 6 describes the largest tax expenditures and the general policy goal motivating the expenditure. There may be a number of reasons for a particular expenditure and we have only given general explanations for the expenditures.

TAX EXPENDITURE REPORT BY REVENUE SOURCE

Year 2005	Year 2006	Year 2007	Year 2008	Year 2009	Year 2010	Year 2011	Year 2012	Revenue Source & Annual Receipts: Sales and Use Tax
$1,300,284	$1,370,499	$1,460,900	$1,408,000	$1,600,000	$1,530,000	$1,547,000	$1,635,000	Food, Drugs, and Medical Appliances Rate Reduction
$967,380	$1,012,367	$1,019,909	$515,000	$417,000	$405,000	$424,000	$405,000	Sales to Exempt Organization
$466,366	$374,460	$370,388	$356,745	$263,000	$109,000	$309,000	$315,000	Traded-In Property Exemption
$212,472	$220,971	$165,320	$207,000	$251,000	$191,000	$241,000	$259,000	Farm Chemicals (Includes Feed and Seed) Exemption
$164,666	$175,020	$260,785	$200,000	$183,000	$174,000	$184,000	$183,000	Manufacturing, Assembling Machinery & Equip. Exemption
$118,671	$126,084	$126,065	$132,993	$112,000	$109,000	$116,000	$121,000	Retailer's Discount
$77,658	$101,176	$101,185	$132,993	$104,000	$102,000	$125,000	$142,000	Gasohol Discount
		$67,700	$111,043	$81,000	$83,000	$107,000	$127,000	Biodiesel Discount and Exemption
$49,981	$68,415	$108,337	$52,112	$47,000	$27,000	$47,000	$74,000	Rolling Stock Exemption
$41,600	$41,600	$31,500	$36,000	$51,000	$53,000	$51,000	$57,000	Farm Machinery and Equipment Exemption
								Gas Tax Holiday (State Sales Tax Exemption on Motor fuels)
$68,879	$36,404	$33,889	$46,728	$43,000	$36,000	$39,000	$43,000	Sales of Motor Vehicles to Non-Resident Exemption
								Revenue Source & Annual Receipts: Individual Income Tax
$828,265	$899,174	$983,015	$983,892	$973,416	$1,005,159	$1,098,914	$1,962,688	Federally Taxed Retirement and Social Security Subtractions
$695,676	$703,068	$712,654	$660,646	$622,244	$654,272	$619,858	$1,035,906	Standard Exemption: Taxpayers and Dependents
$413,605	$443,742	$478,399	$506,668	$521,100	$524,864	$541,786	$554,929	Tax Credit for Residential Real Property Taxes
$70,927	$75,316	$78,903	$88,166	$91,220	$106,239	$105,607	$105,802	Earned Income Tax Credit
$67,904	$70,549	$71,043	$71,896	$72,282	$75,705	$74,354	$79,605	Education Expense Credit
$67,128	$73,927	$82,975	$42,084	$44,274	$43,541	$51,269	$68,146	Other Subtractions
								Revenue Source & Annual Receipts: Corporate Income Tax
$163,186	$248,064	$248,592	$254,112	$259,536	$255,529	$193,487	$217,957	Illinois Net Operating Loss Deduction

Have tax expenditures grown from 2000 to 2012?

Tax expenditures, particularly relative to total revenues, spending, and economic growth, can increase or decrease for a number of reasons. Among these reasons are two that are frequently overlooked:

- First, when a tax expenditure represents a deduction from income, an increase in the statutory tax rate increases the value of the expenditure. For example, the exemption that allows the subtraction of retirement income from Federal Adjusted Gross Income, became more valuable in 2011 when the tax rate increased by 67 percent. This does not hold true for credits that are computed after tax is calculated. The 2011 tax rate increases did not increase the value of the property tax credit, for example, which is dependent on the amount of property taxes paid.

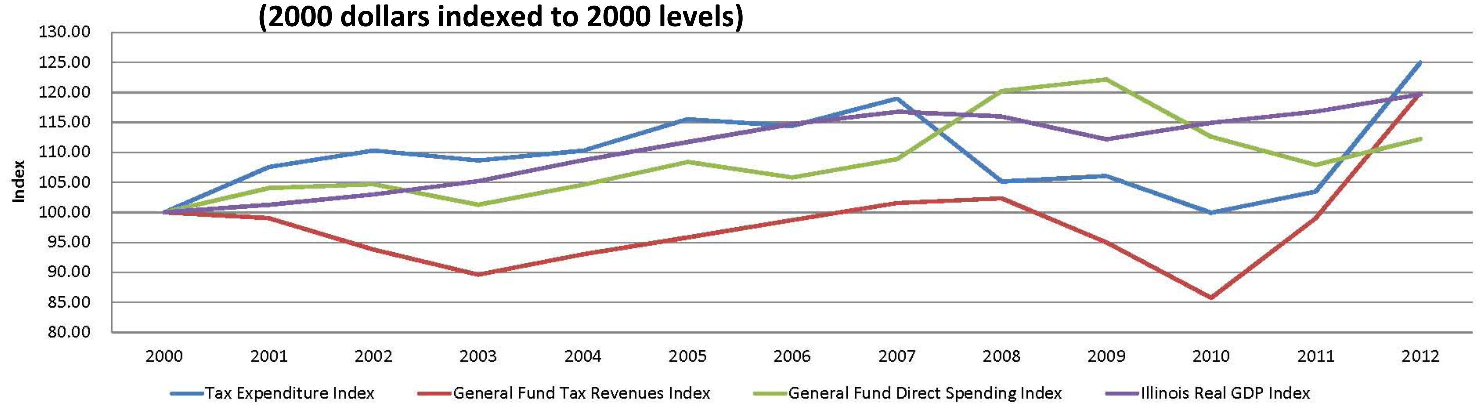
- Second, tax expenditures may not decrease as much as general fund revenues during recessions. For example, taxpayers may decrease their overall spending, but will still purchase groceries (arguably, if they cut back on restaurant meals they may buy more groceries), which will prop up the value of the food and medicine exemption during difficult economic times.

With these caveats in mind, evaluating the growth in tax expenditures within the context of growth in general funds spending, general funds tax revenues, prices and Illinois' economy is appropriate. Real tax expenditures

TABLE 2. Largest Tax Expenditures in Illinois by Recipient Category			
Specific Tax Expenditure	**2012 Expenditures**	**Policy Category**	**Primary Policy Motivation**
SALES AND USE TAXES			
Total Expenditure (Sales and Use Tax)	**$3,512,500**		
Expenditures Detailed Below	**$3,458,500**	98%	% of total sales and use tax expenditures
Food, Drugs, and Medical Appliances Rate Reduction	$1,635,000	Equity Adjustment	Necessities should not be taxed.
Sales to Exempt Organization	$405,000	Equity Adjustment	Charities do good work, should not have to pay tax.
Traded-In Property Exemption	$315,000	Remedy Tax Code	Tax should be on amount spent.
Farm Chemicals (Includes Feed and Seed) Exemption	$259,000	Remedy Tax Code	Business inputs should not be taxed.
Manufacturing, Assembling Machinery and Equipment Exemption	$183,000	Remedy Tax Code	Business inputs should not be taxed.
Retailer's Discount	$121,000	Remedy Tax Code	Sales tax unadministrable without retailers.
Gasohol Discount	$142,000	Incentives	To boost the corn market.
Bio-diesel Discount and Exemption	$127,000	Incentives	To boost the soybean market.
Rolling Stock Exemption	$74,000	Remedy Tax Code	Business inputs should not be taxed/ constitutional question.
Farm Machinery & Equipment Exemption	$57,000	Remedy Tax Code	Business inputs should not be taxed.
Sales of Motor Vehicles to Non-Resident Exemption	$43,000	Remedy Tax Code	Maintain relation between tax paid and benefits received.
Manufacturer's Purchase Credit	$37,500	Remedy Tax Code	Business inputs should not be taxed.
Newsprint and Ink to Newspapers and Magazines Exemption	$32,000	Remedy Tax Code	Business inputs should not be taxed/first amendment issue.
Designated Tangible Personal Property Within Enterprise Zone Exemption	$20,000	Incentives	Encourage development in Enterprise Zones.
Graphic Arts Machinery and Equipment Exemption	$8,000	Remedy Tax Code	Business inputs should not be taxed.
INDIVIDUAL INCOME TAXES			
Total Expenditure (Individual Income Tax)	**$3,915,865**		
Expenditures detailed below	**$3,886,850**	99%	% of total individual income tax expenditures.
Federally Taxed Retirement & Social Security Subtractions	$1,962,688	Equity Adjustment	Benefit retirees.
Standard Exemption: Taxpayers and Dependents	$1,035,906	Equity Adjustment	Make tax code less regressive.
Tax Credit for Residential Real Property Taxes	$554,929	Equity Adjustment	Benefit homeowners.
Earned Income Tax Credit	$105,802	Equity Adjustment	Benefit low-income/working families.
Education Expense Credit	$79,605	Equity Adjustment	Benefit parents who pay school tuition.
Other Subtractions	$68,146	NA	NA
Military Pay Subtractions	$47,663	Incentives	Benefit military members.
Additional Exemption: Blind & Elderly	$32,111	Equity Adjustment	Restore federal benefit.
CORPORATE INCOME TAXES			
Total Expenditure (Corporate Income Tax)	**$318,684**		
Expenditures detailed below	**$300,776**	94%	% of total individual income tax expenditures.
Illinois Net Operating Loss Deduction	$217,957	Remedy Tax Code	See page 12.
Economic Development for a Growing Economy Tax Credit	$31,259	Incentives	Encourage job creation.
Foreign Insurer Rate Reduction	$28,258	Equity Adjustment	Offset other state taxes.
Film Production Services Credit	$11,826	Incentives	Encourage Illinois film production.
Research and Development Credit	$11,476	Incentives	Encourage increased R&D in Illinois

have largely matched general fund revenues in terms of growth over time. From 2000 to 2012, total inflation adjusted tax expenditures grew by 25 percent. During the same period, general fund spending grew only 12 percent and general fund tax receipts grew by 20 percent. Illinois' economy only grew by 19 percent during that period. **Chart 1** shows the index of inflation-adjusted tax expenditures, general fund spending and tax revenues, and Illinois GDP. Figures are indexed to 2000 levels. As discussed below, most of the growth in total tax expenditures is accounted for by growth in individual expenditures.

CHART 1. Tax Expenditures Compared to General Fund Spending and Revenues (2000 dollars indexed to 2000 levels)



Who benefits from tax expenditures?

In their Tax Expenditure Report, the Illinois Comptroller's Office characterizes tax expenditures by beneficiaries.[3] The majority of tax expenditures are received by individuals. Of the $8.3 billion in tax expenditures spent in 2012, 66 percent went to individual taxpayers, 20 percent went to businesses, 6 percent to charitable organizations and other not-for-profits, and the remaining 9 percent went to other recipients. In addition, almost all of the growth in real tax expenditures since 2000 is accounted for by the growth in expenditures to individual taxpayers.

Most of this growth may be attributable to demographic trends and rising incomes. For example, as the demographic profile of the state becomes older, more individuals will claim more retirement income deductions on their personal taxes. And as incomes rise, so too do purchases of tax-exempt prescription drugs. Nationally, real personal consumption of pharmaceuticals and other medical products have increased 58 percent. Since many of these purchases are tax exempt in Illinois, increasing expenditures on pharmaceuticals will lead to increases in tax expenditures. Even food for consumption at home increased nationally by 16 percent from 2000 to 2012.[4] **Chart 2 on page 8** shows the level of real tax expenditures in 2000 and 2012 by recipient category, and **Chart 3 on page 8** shows the level of real tax expenditures for individual taxpayers.

3 Illinois State Comptroller: 2012 Tax Expenditure Report. http://www.ioc.state.il.us/index.cfm/resources/reports/tax-expenditure/fy-2012/

4 Bureau of Economic Analysis, Consumer Expenditure Data.

CHART 2. Changes in Tax Expenditures by Recipient Category, 2000-2012 ($ in Billions)

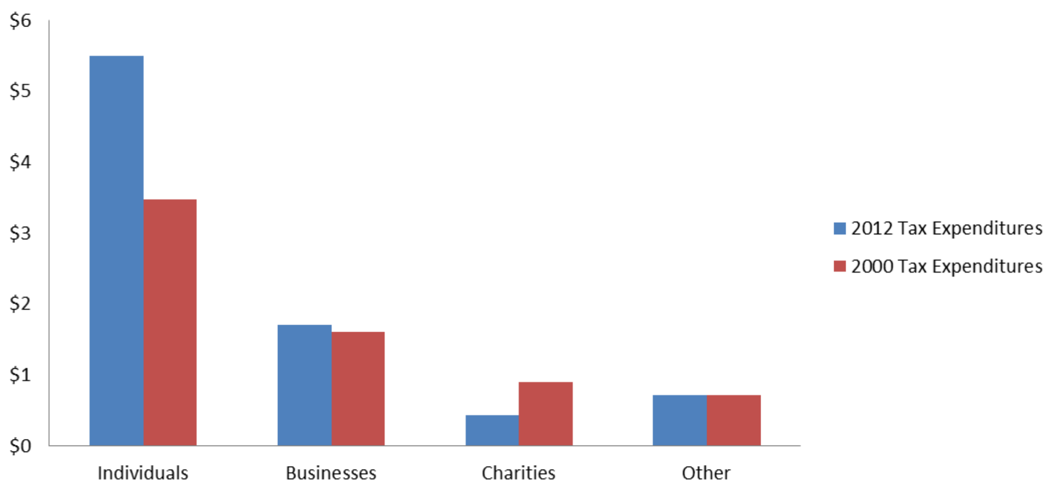
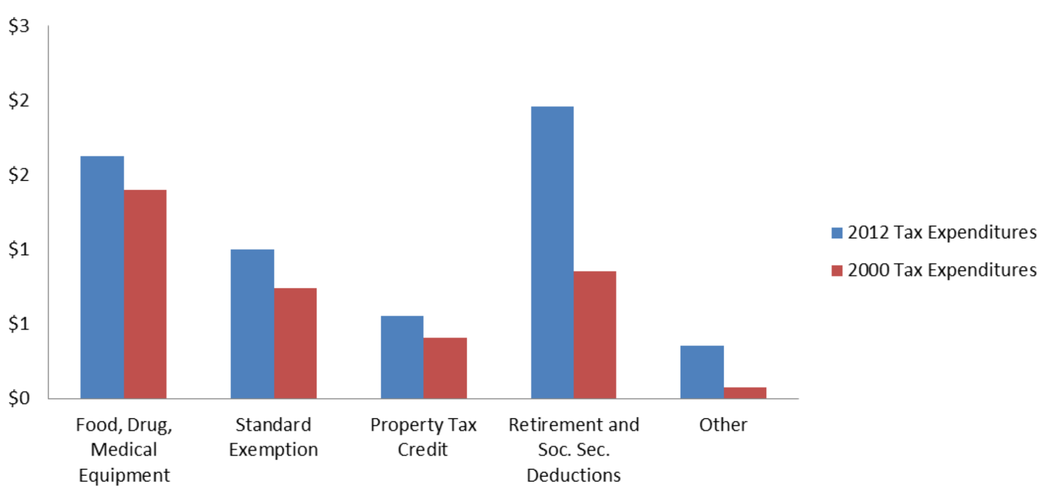


CHART 3. Changes in Tax Expenditures for Individuals, 2000-2012 ($ in Billions)



Tax Expenditures in Focus

Economic Development for a Growing Economy credit (EDGE)

The EDGE credit was created in 1996 and was intended to incent companies to create jobs and invest in Illinois. In FY2012, companies used $31.259 million in EDGE credits. The credit is applied to a company's taxable income to reduce corporate income taxes. To be eligible for the credit, a company must add to the export potential of Illinois, invest either at least $1 million or at least $5 million depending on the size of the company, create or retain at least 25 jobs, and meet investment and employment criteria set by the Department of Commerce and Economic Opportunity (DCEO). The amount of the credit is based on the incomes of the additional jobs created under the program, and the maximum amount of the credit is the amount of new tax receipts collected from Illinois income taxes paid by the new employees of the business. Companies that meet the eligibility criteria may claim the credit for up to ten years for each project.

In real terms EDGE expenditures have not grown considerably since its initial uptake post 2007, when companies became familiar with the credit. From FY2007 to FY2012, real EDGE expenditures grew by $3.7 million, or 16 percent. Some of that growth may be driven by the increase in the income tax rate in 2011.

Gasohol exemption

The gasohol exemption took effect in 1999 and exempts a portion of a retailer's gasohol receipts from sales taxes. In general, gasohol is any motor fuel composed of at least 10 percent biofuel. While retailers and consumers are the direct recipients of this credit, the expenditure is designed to help Illinois' agricultural industries by boosting demand for their products. In FY2012, retailers claimed $142 million in gasohol tax exemptions. In real terms this tax expenditure has grown by more than 270 percent since it was created. Much of that growth may be attributed to the growth in the price of gasoline, which increased from $1.50/gallon to $3.70/gallon during that same period.[5]

Eliminating pyramiding: Manufacturing Machinery and Equipment, Graphic Arts, Farm Chemicals and Machinery Exemptions

Tax pyramiding is a problem associated with a broad-based sales tax and occurs when you tax production inputs for goods that themselves are also taxed. Consider a can of soda sold in Chicago. If the can of soda sells for $1, consumers pay an additional 9 cents in sales taxes. However, consider the production process of making that can of soda, which includes purchases of manufacturing equipment for the can itself and for the soda, advertising services to promote the product, and farm chemicals for the farms that grow the agricultural elements of the soda. If all of these inputs are taxed as well, the price of the can of soda would be much higher than $1, and the general sales tax would be, in part, taxing the taxes paid on the manufacturing equipment used to create the soda. This is called tax pyramiding, where taxes are piled onto taxes. Under egregious tax pyramids, it may be the case that more than half of the price of a product is accounted for by taxes.

This phenomenon is undesirable for two reasons. First, it increases consumer prices, which is bad for almost everyone. Second, it arbitrarily applies a relatively higher real tax rate to some products compared to others. This creates harmful distortionary effects in the economy and undermines the government's ability to purposefully apply tax rates as it sees fit.

[5] US Energy Information Administration. http://www.eia.gov/dnav/pet/hist/LeafHandler.ashx?n=PET&s=EMM_EPM0_PTE_NUS_DPG&f=A

Combined, tax expenditures to eliminate pyramiding amounted to $650 million in FY2012, or about 7 percent of total tax expenditures. Since 2000, tax expenditures for the Farm Chemicals and Machinery exemptions, manufacturing equipment exemption and the rolling stock exemption actually declined in real terms from about $290 million in FY2000 to $240 million in FY2012.

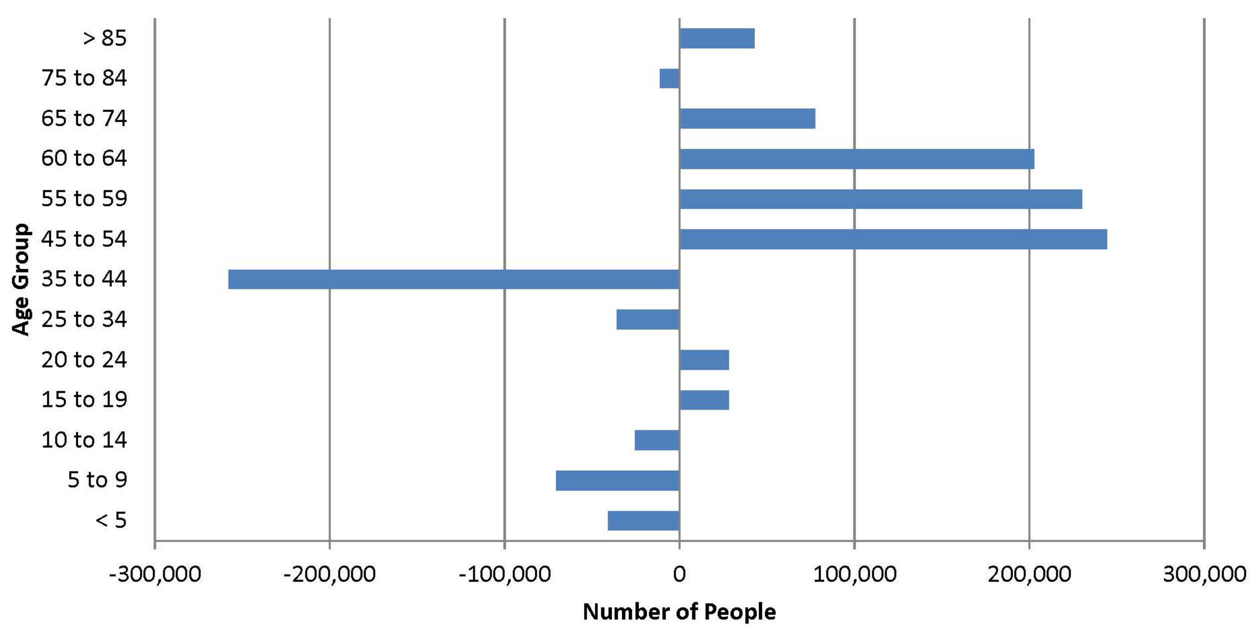
Retirement Income

In an effort to ease income tax burdens on senior citizens, Illinois exempts all retirement income from the state income tax, social security and other retirement income upon which federal income tax is paid. Illinois' treatment of retirement income is among the most generous of all states. As noted above, the retirement income deduction accounts for a significant portion of both total tax expenditures as well as the growth in total tax expenditures. Three factors impact the growth in this tax expenditure over time: increasing the number of taxpayers claiming retirement income deductions, the increasing size of those deductions, and an increase in the state's income tax rate.

Illinois' population is growing older, which leads to increasing tax expenditures on the retirement income deduction. **Chart 4** shows the changes to Illinois' demographic profile from 2000 to 2010.[6] It shows the increasing population of seniors who will likely claim retirement income deductions, which will increase the amount of tax expenditures made by the state.

The increase in Illinois' income tax rate in 2010 lead to a dramatic increase in tax expenditures on retirement income deductions. From 2000 to 2011, expenditures in this area grew by only 30 percent. In 2012,

CHART 4. Change in Illinois Population, 2000-2010



[6]US Census Bureau

that figure jumped to 70 percent because the increase in the income tax rate made the deduction more valuable to those who claim it.

The Earned Income Credit (EIC)

Illinois' EIC falls partly into tax expenditures and partly into direct spending. This is so because the non-refunded portion of the credit is a tax expenditure, but the refunded portion of the credit is simply state spending. The EIC is one of the state's largest income subsidy programs – Illinois spent about $240 million on EIC benefits in FY 2012. Of that, $105 million was in the form of a tax expenditure, while the remaining $135 million was in the form of tax refunds. In real terms, tax expenditures on the EIC since 2001 have doubled from $50 million. Part of that growth was likely caused by the 2009 recession when families' incomes declined sharply and EIC benefits increased.

Property Tax Credit

Illinois residents are allowed to claim a credit based on property taxes paid on real estate. In real terms taxpayers claimed about $555 million in property tax credits in FY2012. Tax expenditures on property tax credits grew at an average annual rate of 2.5 percent per year, making it one of the slowest growing tax expenditures in Illinois. It should be noted that the value of this credit to the taxpayer generally increases with a taxpayer's wealth. This is so simply because it increases with a taxpayer's home value. The value of this credit also generally increases with the provision of local public services, since higher public services tend to correspond to higher property taxes.

Conclusion

Tax expenditures are a major part of the state's revenue and expenditure system. Only a small portion of tax expenditures go to business incentives; at least 66 percent of tax expenditures go towards individual taxpayers, and 18 percent of tax expenditures are designed to correct problems with the tax code. Most of the growth in tax expenditures from FY2000 to FY2012 is accounted for by growth in expenditures for individual taxpayers.

Illinois' Net Operating Loss Primer: Matching Taxation to the Business Cycle

By Robert Ross

Rob Ross does research for TFI. He holds a Masters' in Economics from the University of Illinois at Chicago. His primary areas of research are local property taxation and local public finance.

The Net Operating Loss (NOL) deduction is Illinois' largest single corporate income tax expenditure. In FY 2012, the state forewent $217 million in corporate tax revenues through NOL deductions. The NOL becomes a tax expenditure because of the way Illinois modifies federal taxable income. The Illinois corporate income tax return (1) starts with Federal Taxable Income (FTI) (2) adds back the NOL included in computing FTI, and then (3) allows the apportioned Illinois NOL to be subtracted from apportioned income, and then (4) applies the tax rate. The past 10 years have seen lots of tinkering with the Illinois NOL deduction, all in the name of plugging state budget holes. Before 2004 Illinois followed the federal government in allowing companies to either carry back their NOL deduction two years or carry it forward up to 20 years. From 2003 to 2010, Illinois allowed companies to carry their deduction forward 12 years only. In 2011, Illinois suspended all NOL deductions, but in 2012 reinstated them with a $100,000 cap. Of course all this tinkering has only postponed use of NOLs, in effect borrowing against future revenues.

Introduction

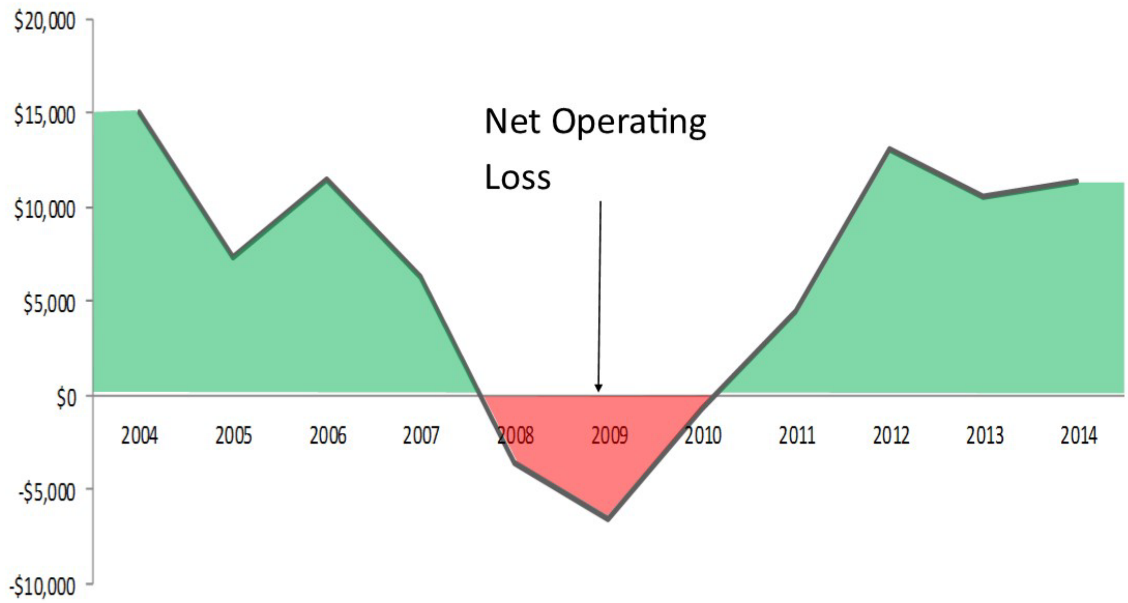
As discussed above, NOL deductions are reported as tax expenditures in Illinois because companies are allowed to apply the deduction to *future* tax liabilities. In FY2012 the state forewent $217 million because of the NOL deduction.

What is a Net Operating Loss and what does it mean for business taxes?

In most cases, a company experiences a NOL when its expenses exceed its income. Consider a hypothetical record store, Rodríguez Records, in a hypothetical state with a fixed corporate income tax rate. The store generates approximately $100,000 per year in income and costs $85,000 per year to operate. Over any sufficiently long period of time it is likely that the Rodríguezes will have a "bad year" or two, during which its expenses exceed its income. **Chart 1** shows the annual profits of this hypothetical record store over a 10-year period.

In Chart 1, the red area represents a net operating loss where the record store made

CHART 1. Rodriguez Records' Profits, 2004-2013



negative profits. Over the entire decade, Rodríguez Records made $68,619 in profits (green plus red). But during the three years from 2008 to 2010, the store's net income was $-10,926 (red area). Note that this is still a profitable company that generated profits, on average, of $6,861 per year.

How should Rodríguez Records' NOL factor into its tax obligation? Here we illustrate some possible approaches. For this example we assumed that the tax rate on corporate profits was a constant 7 percent from 2004 to 2014.

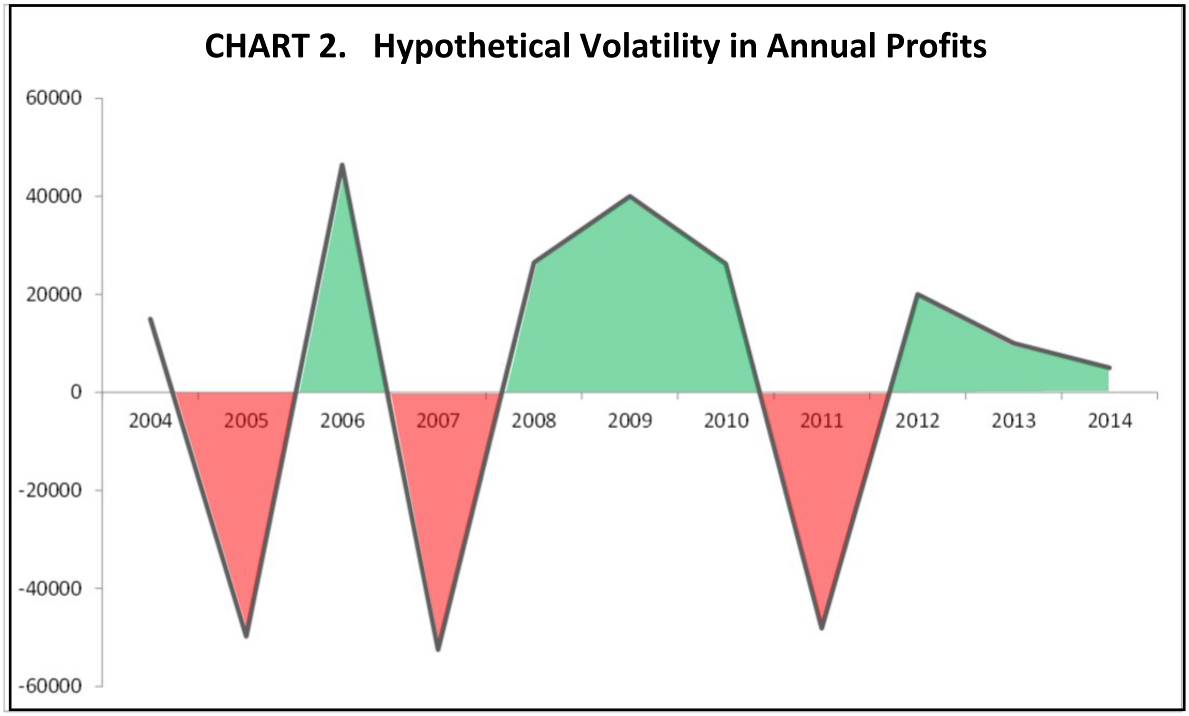
Option 1: NOL only impact taxes for the years in which it occurs.

The first option is to simply let Rodríguez Records pay no corporate income taxes from 2008 to 2010, and then continue to tax its income at the normal rate after that. Under this option, the record store would pay $5,568 in income taxes from 2004 to 2014.

Option 2: NOL is allowed to impact taxes for years other than those in which it occurs

The second option is to recognize the ups and downs of the normal business cycle, and the fact that the 12-month tax year is an artificial time frame for evaluating (and taxing) a business. This can be achieved by subtracting the NOL either from past or future net income. If the NOL is subtracted from past income, or *carried back*, the taxpayer files an amended tax return for the earlier year, claims a refund for the difference between what they paid in taxes and what they would have paid with a lower net income. If the NOL is subtracted from future income, it is *carried forward.* (Illinois currently allows NOLs to be carried forward.) With the NOL carried forward, Rodríguez

Records would only pay $4,803 in corporate income taxes from 2004 to 2014. **Table 1** compares Rodríguez Records' taxes with and without carry-forward.



Why might states allow companies to carry their NOLs forward?

NOL deductions serve the purpose of breaking the artificial tie between a corporation's tax year and its profits, most strikingly with businesses whose profits are cyclical.

To see this, consider the total taxes Rodríguez Records' would pay under each of the above options:

TABLE 1. Rodriguez Records' Profits and Taxes, 2004-2014		
Gross Profits	$79,545	
Gross Losses	-$10,926	
Net Profits	**$68,619**	
Taxes	**Without Carry-Forward**	**With Carry-Forward**
Total Taxes	$5,568	$4,803
As % of Net Profits	8.11%	7.00%

The impact of ignoring the NOL is most striking when you look at the tax rate that Rodriquez pays. Notice that, even though the statutory tax rate used in this example is 7 percent, the total taxes Rodríguez Records' pays as a percentage of its total profits is 8.11 percent if it is not allowed to carryover its NOL. Without carryover the average income tax rate faced by a company actually *increases* with the size of a company's losses. To see this, consider the effect on average tax rate of increasing the NOL by $1,000, so that Rodríguez Records' net income from 2008 to 2010 is -$11,926. Under this scenario Rodríguez Records' average tax rate would be 8.23 percent rather than 8.11 percent. With carryover, the average tax rate a company faces is equal to the statutory rate of 7 percent.

Consider further a company whose annual profits are highly volatile as in **Chart 2**.

This hypothetical company has profits of $38,768 from 2004 to 2014. If it were not allowed to carry its regular NOLs forward, it would pay $13,238 in corporate income taxes, or about 34 percent of its profits. Clearly this is well above the statutory corporate income tax rate. Such a tax regime would be unfair to this company since it would be simply a product of the volatility of its profits over time and not a product of a conscious policy choice on the part of lawmakers.

From these examples we can see that NOL deductions are necessary so that the *de jure* tax rate is equal to the *de facto* tax rate on corporate profits. If NOL deductions are not allowed the state ends up imposing a higher tax rate on net profits on industries that are more exposed to the business cycle. This is not a good policy; companies in these industries already face a less favorable business climate and the state tax code should not further exacerbate their difficulties. Furthermore, it is not fair to impose a higher tax rate on companies simply because they operate in volatile industries. The tax rate on corporate profits should be the same for industries whose profits are volatile and those whose profits are stable.

Additionally, allowing carryovers encourages businesses to maintain payrolls and other beneficial activity during recessions. For example, Rodríguez Records may be less likely to lay off or cut back the hours of its store clerks or other employees if it knows that its losses will reduce its future tax liabilities. And during recoveries companies with NOL deductions increase their payroll faster than those without NOL deductions. In this way, NOL deductions allow Illinois to better weather and recover from economic downturns.

Conclusion

Illinois' corporate tax code should treat companies equally and fairly, and should encourage employment and income growth. NOL deductions help achieve these goals by equalizing corporate income tax rates across sectors of the economy, and by discouraging layoffs during recessionary periods and encouraging faster job growth during recoveries. As such, NOL deductions are an integral part of a fair and economically sound tax code.

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APRIL 9 & 10

Wednesday, April 9th
Governor's Mansion, Springfield
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- 6:45 Dinner for TFI members and guests

Thursday, April 10th
Sangamo Club, Springfield
- 8:15 a.m. Registration
- 8:30 - 11:00 Legislative Seminar

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